

ANALYSIS OF ORIGINAL BILL

Author: Monteith Analyst: Jeani Brent Bill Number: SB 1881

Related Bills: See Legislative History Telephone: 845-3410 Introduced Date: 02/19/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Research and Development Credit/Businesses Located in Merced County

SUMMARY

This bill would provide businesses operating a trade or business in Merced County a credit for 75% of the amount paid for research and development performed at the taxpayer's trade or business located in Merced County.

This bill also would make changes to the Government Code, relating to research and development incentive payments. These changes would not impact the department and are not discussed in this analysis.

EFFECTIVE DATE

This bill would apply to taxable and income years beginning on or after January 1, 1998, and before January 1, 2009.

LEGISLATIVE HISTORY

AB 1042 (Stats. 1997, Ch. 613), AB 1067, AB 1356, AB 1499 (1997); AB 3408 (1996), SB 38 (Stats. 1996, Ch. 954); AB 365, AB 397, AB 917, SB 681 (1995); AB 2407 (Stats. 1994, Ch. 949); AB 1824, AB 1893, AB 1911 (1993), SB 671 (Stats. 1993, Ch. 881); SB 1853, AB 2508 (1992); AB 274 (Stats. 1990, Ch. 452); AB 802 (Stats. 1989, Ch. 1352); AB 2130 (Stats. 1988, Ch. 11); AB 53 (Stats. 1987, Ch. 1138).

SPECIFIC FINDINGS

Existing federal and state laws provide various tax credits that are designed to provide tax relief for taxpayers who must incur certain expenses (e.g., child and dependent care credits) or to influence behavior, including business practices and decisions (e.g., research credits).

Existing federal and state laws provide a credit for specified percentages of the amount of a taxpayer's qualified research expenditures. Qualified research expenditures eligible for the credit consist of: (1) "in-house" expenses of the taxpayer for research wages and supplies used in research; (2) certain time-

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
Gerald H. Goldberg 3/13/98

Agency Secretary Date

By: Date

sharing costs for computer use in research; and (3) a specified percentage of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. Further, the research must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must pertain to functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors. In addition, research does not qualify for the credit if conducted after the beginning of commercial production of the business component, if related to the adaptation of an existing business component to a particular customer's requirements, if related to the duplication of an existing business component from a physical examination of the component itself or certain other information, or if related to certain efficiency surveys, market research or development, or routine quality control.

SB 1881 would provide businesses operating a trade or business in Merced County a credit for 75% of the amount paid for research and development performed at the taxpayer's trade or business located in Merced County. Since this bill does not specify otherwise, the general rules regarding the division of credits among taxpayers would apply. The credit would not reduce regular tax below tentative minimum tax for alternative minimum tax purposes.

This bill also would provide that the Legislature intends the bill to encourage activity that will facilitate the success of the new University of California campus that is planned to be constructed in Merced County.

Policy Considerations

This bill raise the following policy considerations:

1. This bill would allow taxpayers in certain circumstances to claim two credits – the regular research and development credit and the credit provided under this bill – for the same item of research expense.
2. Although this bill requires that a qualified taxpayer "operate a trade or business located in the County of Merced," utilization of the credit is not limited to the taxpayer's business activities within Merced County. This differs from the enterprise zone and Los Angeles Revitalization Zone (LARZ) credits and net operating loss rules in that many of those credits and net operating loss deductions may only be offset against tax liability attributable to the enterprise zone or LARZ taxable or net income.
3. This bill would allow taxpayers in certain circumstances to claim multiple special tax benefits (one or two credits and a trade or business expense deduction) for the same item of research expense.

Implementation Considerations

This bill raises the following implementation considerations:

This bill defines the term "qualified research and development" as research and development performed in a trade or business located in Merced County. This bill does not, however, define "research and development." Consequently, this term may be variously interpreted by taxpayers and the department and may result in disputes between the department and taxpayers.

This bill does not specify whether, in the case of a partnership or S corporation, the 75% limitation applies at the entity level or at the partner/shareholder level.

This bill would allow an unlimited carryover for the research and development credit. Recently enacted credits have contained a limited carryover since credits typically are exhausted within eight years.

FISCAL IMPACT

Departmental Costs

If this bill is amended to resolve the implementation consideration addressed in this analysis, the bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses under the Personal Income Tax and Bank and Corporation Tax Laws are estimated to be as follows:

Effective Tax Years After December 31, 1997 Assumed Enactment After June 30, 1998 (in millions)*			
1998-9	1999-0	2000-1	2001-2
(\$15)	(\$20)	(\$45)	(\$80)

* Rounded to the nearest \$5 million.

It is assumed that for taxpayers with unitary affiliates this credit could be applied against the tax liability of the combined group.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Estimate Discussion

The above revenue impact was estimated as follows. First, the 1994 U.S. total research and development was prorated to California based on the 1991 California and U.S. research and development levels given by the National Science Foundation (NSF). Next, Merced research and development in 1994 was estimated as the product of California research and development and the ratio of Merced over California nonagricultural employment. Merced research and development was adjusted further to account for the following factors:

1. Existing businesses in Merced tend to be involved in less research and development than in other parts of the state.
2. Due to the lack of a specific definition, many taxpayers would claim research and development expenses that are not included in the NSF research and development data and do not qualify under current law for the incremental research and development credit.
3. It takes time for taxpayers to learn about the new tax laws and to fully implement the proper responses.
4. Many businesses outside of Merced would respond to SB 1881 by either moving or expanding research and development activity into Merced.
5. The research and development credit under SB 1881, as currently written, is not a qualified credit for alternative minimum tax (AMT) purposes.

Future Merced qualified research and development expenditures were projected using the Department of Finance's projection of corporate profits. Finally, the revenue impact was estimated from the amount of qualified research and development credits that could be applied against available tax liabilities.

If SB 1881, as currently written, is enacted, taxpayers would receive multiple benefits from conducting research and development in Merced – research and development incentive payments from the Merced Board of Supervisors, the incremental research and development credit under current law, business expense deduction, and this proposed research and development credit. Furthermore, it is assumed that the research and development credit generated under this bill by a company located in Merced could be used to offset taxes incurred by the same company's operations located elsewhere.

BOARD POSITION

Pending.